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C O N F I D E N T I A L SECTION 01 OF 03 PRAGUE 001173

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TAGS: ECON EFIN PGOV PREL MARR EZ
SUBJECT: CZECH REPUBLIC: 2007 DRAFT BUDGET PUTS EURO ADOPTION OFF COURSE, RAISES CONCERNS ON DEFENSE SPENDING, AND HAS POTENTIAL TO FORCE A GRAND COALITION

REF: A. PRAGUE 57
¶B. PRAGUE 1167

Classified By: Political and Economic Counselor Michael Dodman for reasons 1.5 b+d

¶1. (C) SUMMARY AND COMMENT: For the first time since joining the EU, the Czech Republic will miss its Maastricht convergence program target for the budget deficit, thanks to legislation passed in the run-up to the June 2006 general elections that significantly increases social spending. Compared to the 2007 convergence program deficit target of 3.3% of GDP, the Czech government is estimating a consolidated government deficit in the range of 4.2 - 5% of GDP. Defense spending is set to drop from 1.74% of GDP in 2006 to 1.55% of GDP in 2007. Unless these laws on social benefits are repealed or reformed, euro adoption will not be possible as planned in 2010 or even beyond. The budget bill is the first significant legislation that the new government will need to address after the vote of confidence, and it has already become a political hot potato with accusations flying between political parties and senior statesmen (President Klaus and former PM Zeman) being drawn into the debate. Given the political situation, we do not believe the new government's complaints about the draft budget will translate into real cuts in spending. More likely, with the Czechs well aware of the budget problems confronting the Hungarian government, is that the fiscal situation will become a pretext for an arrangement under which the two main parties share power, including a possible grand coalition government. END SUMMARY AND COMMENT

¶2. (C) SOCIAL TRANSFERS INCREASE BY 16%: Problems with the 2007 draft budget, which the new ODS-led government inherited from their predecessors, have dominated local news in recent weeks. The fiscal problems are the inevitable (but previously ignored) result of laws passed prior to the June 2006 general elections that increased social spending by about 16%. The draft budget was unveiled on August 14 by former Finance Minister Bohuslav Sobotka, who is now the Chair of the Budget Committee in Parliament. Deputy Minister of Finance Eduard Janota (who has retained his position in the new government) confirmed for embassy on September 15 that the 2007 budget problems are significant and cannot be overcome without legislative changes. Janota explained that the 2007 state budget deficit is set at CZK 88 billion (about USD 4 billion), but there were two other figures to consider -- additional legislation on social transfers currently

before Parliament (CZK 26 billion) and extrabudgetary funds (at least CZK 31 billion). Many different deficit figures have appeared in the press, but the most frequently cited figure is CZK 119 billion (the CZK 88 billion state deficit plus CZK 31 billion in extrabudgetary funds). In reviewing the draft 2007 budget he inherited, new Finance Minister Vlastimil Tlusty determined that figures considered "extrabudgetary" in the past must be included in the consolidated government budget, including the CZK 31 billion deficit of the National Property Fund (FNM). (NOTE: FNM was the government body in charge of implementing privatization of state owned enterprise but no longer exists as an independent entity and has been brought under the Ministry of Finance. END NOTE.) In the end, Janota estimated that the 2007 budget deficit would be at a minimum 4.2% of GDP but could be as much as 5% of GDP. (NOTE: Janota is using his Ministry's 2007 nominal GDP forecast of CZK 3443 billion. END NOTE.)

¶3. (C) DEFENSE MINISTRY PROTESTS LOUDLY: The Ministry of Defense's 2007 budget is proposed as CZK 53.37 billion or 1.55% of GDP, down from its 2006 budget of CZK 55.69 billion or 1.74% of GDP. Consequently, the previous Minister of Defense Karel Kuehnl was the only member of the previous government to vote against the draft budget and complained loudly and publicly that this represents a 15% decrease from the budgetary targets the GOCR had set in 2004, and could threaten the Czech Republic's NATO commitments. During his September 19 meeting with the Ambassador, new Defense Minister Jiri Sedivy flagged the 2007 budget as a problem. He said that while he was working to ensure that operations for 2007 would be unaffected, maintaining operations towards the end of the decade would be a "severe challenge." In a meeting with Ambassador on September 21, new PM Mirek

Topolanek admitted that the defense budget cuts could have an impact on future deployments, but offered no suggestion of how his government planned to address the problem (ref B)

¶4. (U) In addition to Defense, spending for all other ministries except Labor and Social Affairs will drop next year if the 2007 budget is adopted as proposed:

Foreign Affairs	CZK 4.68 bn or .14%/GDP	(down from .145%)
Defense	CZK 53.37 bn or 1.55%/GDP	(down from 1.74%)
Finance	CZK 15.74 bn or .46%/GDP	(down from .47%)
Labor & Social Affairs	CZK 421.68 bn or 12.25%/GDP	(up from 11.16%)
Environment	CZK 3.8 bn or .11%/GDP	(down from .44%)
Industry & Trade	CZK 9.2 bn or .27%/GDP	(down from .43%)
Transportation	CZK 12.05 bn or .35%/GDP	(down from .74%)
Agriculture	CZK 12.57 bn or .37%/GDP	(down from 1.24%)
Education	CZK 104.96 bn or 3.04%/GDP	(down from 3.4%)
Health	CZK 7.16 bn or .21%/GDP	(down from .26%)
Justice	CZK 19.37 bn or .56%/GDP	(down from .58%)

¶5. (SBU) EURO ADOPTION MUST BE DELAYED: Deputy Finance Minister Janota confirmed for us what both PM Topolanek, his predecessor Jiri Paroubek, and Central Bank Governor Tuma have said publicly -- the 2007 budget means that euro adoption will have to be delayed. The Paroubek government had announced last year that the Czech Republic would adopt the euro on January 1, 2010. When asked when he thought euro adoption might now be possible, Janota exclaimed "never" unless laws on social benefits are changed because there is

no way to meet the Maastricht convergence criteria otherwise. The 2005 convergence program deficit target was 4.8% of GDP and the actual deficit was 2.6% of GDP. The 2006 convergence program deficit target was 3.8% of GDP and the deficit is expected to be 3.8% of GDP. The 2007 convergence program target is 3.3% and the budget deficit is estimated between 4.2 - 5%. So far there has been little public complaint about the date for euro adoption likely slipping into the future; most economists agree that the euro is not critical for the Czech economy, given the strong economic performance to date. However, with Slovakia on track to adopt the euro in 2009, and the Czech Republic due to hold the EU Presidency in 2009, this could become a political issue in the future.

¶6. (C) ROARING CRITICISM FROM ALL SIDES: Former Finance Minister Sobotka, who is now head of the Parliamentary Budget Committee, announced in 2003 with great fanfare an amendment to the law on budgeting rules that introduced medium-term fiscal discipline by requiring mid-year budget reviews to provide a three-year outlook on expenditure ceilings that was supposed to guide future budgets. Sobotka ignored his own law with the 2007 budget by breaching his most recent expenditures ceiling for 2007 (as he explained to Ambassador in a meeting in late August, part of the problem stemmed from the fact that the parliament had increased the social benefits even beyond what his government had proposed). Economists point out that budget deficits in times of economic growth (6.2% GDP growth in 2005, same forecasted for 2006) will only exacerbate the business cycle. Furthermore, they also point out that this will limit the future government's ability to pursue needed reforms in pension and healthcare. Czech National Bank Vice Governor Ludek Niedermayer has called the 2007 budget "the worst and the most dangerous in recent years." President Klaus said that recent government had wasted the recent period of economic growth. Even former PM Milos Zeman, who, controversially, Finance Minister Tlusty has consulted on the budget, complained about the excessive social spending that his successor as party chair, Paroubek, had introduced.

¶7. (SBU) BUDGET APPROVAL LIKELY TO BE DELAYED: The cabinet will meet in special session on September 25 to vote on the

2007 draft budget. By law, the government-approved budget must be submitted to Parliament by September 30; in Parliament it passes through a three-step (three readings) process. There are several upcoming events that could delay action on the budget in Parliament: the October 5 or 6 vote of confidence on the current minority government, October 20 - 21 municipal and Senate elections, and the November 14 - 17 Congress of the ruling Civic Democrats (ODS). Given the fact that the center-right ODS is concerned about the budget deficit, but does not have the political mandate to push through controversial cuts in social spending, it is quite possible that final approval of the budget will not take place before the end of the year. This does not present any constitutional challenges and has happened in the past. A provisional budget (or continuing resolution) based on the current year's budget would be put in place until agreement is reached on a final budget.

¶8. (C) COMMENT: The budget is the first important piece of legislation that the ODS minority government will have to take up after the vote of confidence. Even if it were to win that vote (considered unlikely), it does not have a political mandate to put in place the necessary cuts in social spending. With ODS calling for early elections next spring, it has even less political incentive to do so. Therefore we expect no significant revisions to the draft budget when the government considers it on September 25. However, ODS in general and Finance Minister Tlusty in particular are in favor of fiscal discipline, and are certainly concerned about some of the spending cuts -- particularly in defense spending -- contained in the draft budget. With the fiscal and political situation confronting the Hungarian government

presenting a vivid example, we believe ODS and other parts of the Czech political leadership are sincere in their desire to get the Czech Republic back on the track set out in the Maastricht convergence program as quickly as possible. In light of the results of the deadlocked June election, the best political solution to achieve this is a grand coalition bringing together ODS and CSSD, and putting off elections until 2010. Both parties have said they are opposed to a grand coalition, although the President and many others are known to favor it. A "crisis" like the 2007 budget could offer a face-saving excuse to bring the grand coalition -- or some other form of ODS-CSSD cooperation -- into effect.
GRABER